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Methodology development at the
National Audit Office.

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Office of the
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DISCUSSION PAPER NO. 40

METHODOLOGY DEVELOPMENT AT THE NATIONAL AUDIT OFFICE

by

David Marshall

December 1984

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SYNOPSIS

In 1979 the National Audit Office (NAO) carried out a substantial review of its financial audit standards and procedures following intense public scrutiny of its role in the Crown Agents Corporation affair. Crown Agents, a client of the Office, had made substantial losses in questionable real estate speculation. Also at this time, parliamentary interest in the Office was mounting as the National Audit Act began to take form.

As a result of the review, the NAO embarked on developing, implementing and training staff to apply much upgraded financial audit methodology. This was finally accomplished by 1983. Also in 1983, a new Audit Guidance Division was set up to develop and maintain audit methodology for the Office. The Division has 18 staff and is headed by a Director (PX1-2 equivalent). Its approximate annual expenditure on financial audit methodology development is \$265,000; on value-for-money methodology development, \$45,000. It carries out an effective quality assurance function for financial audit at an approximate cost of \$114,000 a year. Other costs involve course development at about \$46,000 annually.

The NAO has a high standard of financial (certification) audit methodology for both appropriation and commercial accounts. Its quality assurance function for financial audit, concerned with the cost as well as the thoroughness of audits, is also very effective. The NAO has provided substantial advice to Treasury on the form of both commercial and appropriation accounts.

The development of value-for-money audit methodology is substantially behind that of the financial audit. At present, emphasis is being placed on the planning stage -- identifing issues and developing audit approach. Still, considering the Office has been given a mandate to measure effectiveness (not just to evaluate arrangements in place for measuring), there is a long way to go in developing value-for-money methodology.

One remarkable feature of methodology development at the NAO is its freedom from red tape. Methodology is usually developed at the Chief Auditor (AU-4) level -- relatively junior by OAG standards. The methodology is circulated for three to four weeks among senior management for comment; it is implemented without much delay. While there has not been significant innovation at the NAO, the methodology that has been developed is of a high standard and has been accomplished at a relatively low cost.

METHODOLOGY DEVELOPMENT AT THE NATIONAL AUDIT OFFICE

Background

For many years, the National Audit Office (NAO) has had audit guidelines and checklists of various kinds. During 1976, the Office was struck by a crisis that amounted to a near audit failure. The Crown Agents Corporation, a client of the Office, had lost some £200m in real estate speculation, in which it should not have been engaged. The Public Accounts Committee (PAC) wanted to know why the Audit Office had not picked it up.

After two years of judicial and quasi-judicial hearings into the affairs of Crown Agents, the Audit Office was excused from blame. However, Sir Douglas Henley, the former Controller and Auditor General, considered that the matter had been a "near miss" and was determined that certification audit practices throughout the Office would be significantly upgraded. The result was a management review of auditing standards, practices, and organization carried out in 1978. Senior members from professional firms participated as well as a senior representative from the Department of the Treasury.

The review found that financial and certification audit standards needed to be greatly strengthened. It also found that senior managers in the Office were spread too thinly -- a director (equivalent of a PX in the Canadian Office) having on average 60-70 staff to manage.

As a result, two things happened: in 1979, a senior manager from the firm of Arthur Andersen joined on an 18-month secondment to help the Audit Office upgrade its audit procedures; and more directors and smaller divisions were created. The Arthur Andersen manager conducted a survey of current Office practice and proposed major changes. These were accepted by the Controller and Auditor General and there followed the detailed development over the next two years (1980-82) of standards, guidelines, checklists, and training courses for the audit of departmental appropriation accounts. In a parallel move, a manager from

Price Waterhouse joined the Office on secondment in 1980 and, by 1982, had developed methodology and a course for the audit of commercial accounts.

Responsibility for overseeing development of the financial audit methodology rested with the Office's Policy and Planning Division and loosely with an internal Standards Committee.

The Audit Guidance Division

Early in 1983, a new division called Audit Guidance was created to concentrate on methodology matters. At this point, the Office had developed the major part of its new financial and certification audit methodology as described above. Also, courses on the methodology had been run for most of the staff. The responsibilities of the Audit Guidance Division are as follows:

- development and maintenance of financial audit methodology;
- monitoring of compliance with financial audit standards (quality assurance);
- development and maintenance of value-for-money audit methodology;
- development of training in areas where new methodology is being introduced;
- maintenance of the Office's Audit Manual which has, in addition to methodology, sections on the Office's mandate, etc.; and
- advice to Treasury on new form of appropriation and commercial accounts.

The Audit Guidance Division is staffed as shown in Figure I.

Costs for 1983-84 are indicated in Figure II. Both figures are at the end of this paper.

Financial (Certification) Audit

The NAO methodology in this area is highly developed and compares favourably with best practice in the professional firms. It deals with all aspects of financial audit for both departmental appropriations and commercial accounts. All Office staff up to the Deputy Director (DX equivalent) level have received courses on the financial audit methodology.

Generally a systems-based audit approach is used, though emphasis is slowly turning to greater substantive testing. The Office methodology has been standardized and covers all aspects of planning, fieldwork and supervision. The Office has taken quite a credible stab at giving guidance to its auditors on such difficult issues as materiality, risk, and the audit of compliance with regulations; research is continuing into these areas. At present, the firm of Arthur Young has been commissioned to develop a detailed strategy for regularity audit. Work is also going on to refine the materiality-risk-statistical sampling sections of the audit methodology.

As a matter of interest, in the NAO most appropriation accounts are reviewed by either the Director (PX equivalent) or Deputy Director (DX equivalent) and are sent to the Controller and Auditor General for signature with little further review. Large or contentious accounts are sometimes reviewed by an Assistant Auditor General. For commercial accounts the same rules apply. Here, each audit team is supplied with the Institute of Chartered Accountants equivalent of GAAP and is expected to ensure compliance. There is no review independent of the audit team.

Quality Assurance - Financial Audit

The NAO does not claim to have an official quality assurance process. However, its current practices contribute quite effectively to improving and maintaining standards of financial audit.

Independent of the line review functions called for by the Office methodology, the Audit Guidance Division runs what are called Implementation Advisory Teams. There are four such teams, each consisting of one NAO senior auditor (OAG equivalent of an AU-3) and one manager on secondment from a public accounting firm (normally one of the big eight).

These teams, which I have observed in action, perform the following functions:

(i) They provide advice and brainstorming to audit teams at the planning stage of the audit. This service is voluntary. In practice, most of the audit teams come to them to clarify such matters as materiality, audit scope, identification of key controls, sampling techniques, etc.

I sat in on several of these "advice" sessions and found them very effective. The NAO senior auditors are keen, and they are backed up by sound financial auditing experience from the seconded members from the firms. The atmosphere was one of healthy challenge and debate. The methodology team was pressed hard about why its advice should be accepted. The line audit teams were equally pressed to explain the value of doing things "the old way".

(ii) The Implementation Teams also carry out a program of post-audit quality reviews. These are done officially to assess the "implementation" of the new certification methodology. In fact, they are thorough quality reviews that take two to three weeks for the two-member teams to complete. The reviews follow a checklist and cover the entire conduct of the audit, from the planning stage all the way through the final certification. There is substantial emphasis on both the thoroughness of the audit and its efficiency. I saw several comments in the reports of the review teams dealing with over-auditing and suggestions for a more efficient audit.

The quality review reports go only to the Director responsible for the audit and the Director in charge of Audit Guidance Division. The audit director must respond in writing to the Audit Guidance Division on its recommendations. The whole process is kept deliberately confidential at the director level. Only a summary report, without identifying individual divisions, goes to the senior management group.

About 24 major audits have received quality reviews in the past 2 years; about 15 are scheduled to receive them in the next 12 months.

Value-for-Money Audit Methodology

The development of methodology for value-for-money (VFM) audits is considerably undernourished when compared with the certification audit side. The present methodology deals only with the planning stage, the requirement to carry out surveys, and the mechanics of reporting the VFM audit findings. There is no methodology in place as yet for the bulk of VFM audit work. This reflects the newness of the VFM mandate. Although the Audit Office has done VFM work for many years, it has been largely as an extension of the financial and regularity audit, and not as a separate discipline. At present, the Office very much relies on the experience of its auditors to identify a VFM issue and pursue it. There is a form of guidance through the process of submitting proposals for new studies. During this process, audit directors must show the senior management group what they intend to study, what the likely reporting points will be, and how they propose to go about the audit. These proposals are discussed by senior management in the form of a meeting between the audit director, the responsible Assistant Auditor General, the Deputy Controller and Auditor General, and the Controller and Auditor General. During these meetings, senior management uses its collective wisdom to advise the audit director on his approach or, if appropriate, to cancel the study. During a two to three-hour meeting, senior management may consider three to four proposals from one division. There is no further guidance on methodology. Directors are responsible for conducting approved studies in the way they see fit.

To date, the Audit Guidance Division has issued the planning and reporting procedures for VFM audits and has developed a three-day training course for staff on these subjects. There are no plans yet for further development of methodology. My discussions with the Director of the Audit Guidance Division, as well as with the Controller and Auditor General and various Assistant Auditors General, indicate that the NAO is keen to pursue a more methodical approach to identifying VFM studies and planning the audits. Detailed audit guides are not at this time a priority.

Advice to Treasury on Form of Accounts

The NAO, through the Audit Guidance Division, has been active in advising Treasury on the form of both commercial and appropriation accounts. In the case of commercial accounts (financial statements for quasi-independent trading bodies such as the Royal Ordanance Factory), the NAO actually drafted a Treasury letter setting out the form of accounts and disclosure requirements, that would correspond to practice in the private sector. Departmental appropriation accounts are a more complex issue, and work is going on to prod Treasury into better disclosure.

Methodology Approval Process

The interesting feature of methodology development in the NAO is the degree of informality with which it is carried out. Most of the existing methodology and accompanying training courses have been developed by small groups of people. Usually this has been a senior auditor (AU-3 equivalent), a manager seconded from an accounting firm, and a chief auditor (AU-4 equivalent).

The methodology is reviewed by the Director of Audit Guidance Division (PX equivalent) and circulated to the senior management group (C&AG, Deputy C&AG, AAGs). If no objections are received within three or four weeks, the methodology is issued. There is no methodology committee or its equivalent, and the methodology is not circulated to outside advisers. Despite this apparent

informality, the quality of methodology developed so far is of a high standard. It should be noted, however, that the NAO has not been involved in breaking any new ground. In fields where audit practice is relatively new -- for example, in computer audit and value-for-money audit -- the NAO still has quite a way to go in its development program.

Figure I: Audit Guidance Division: Organization - Costs

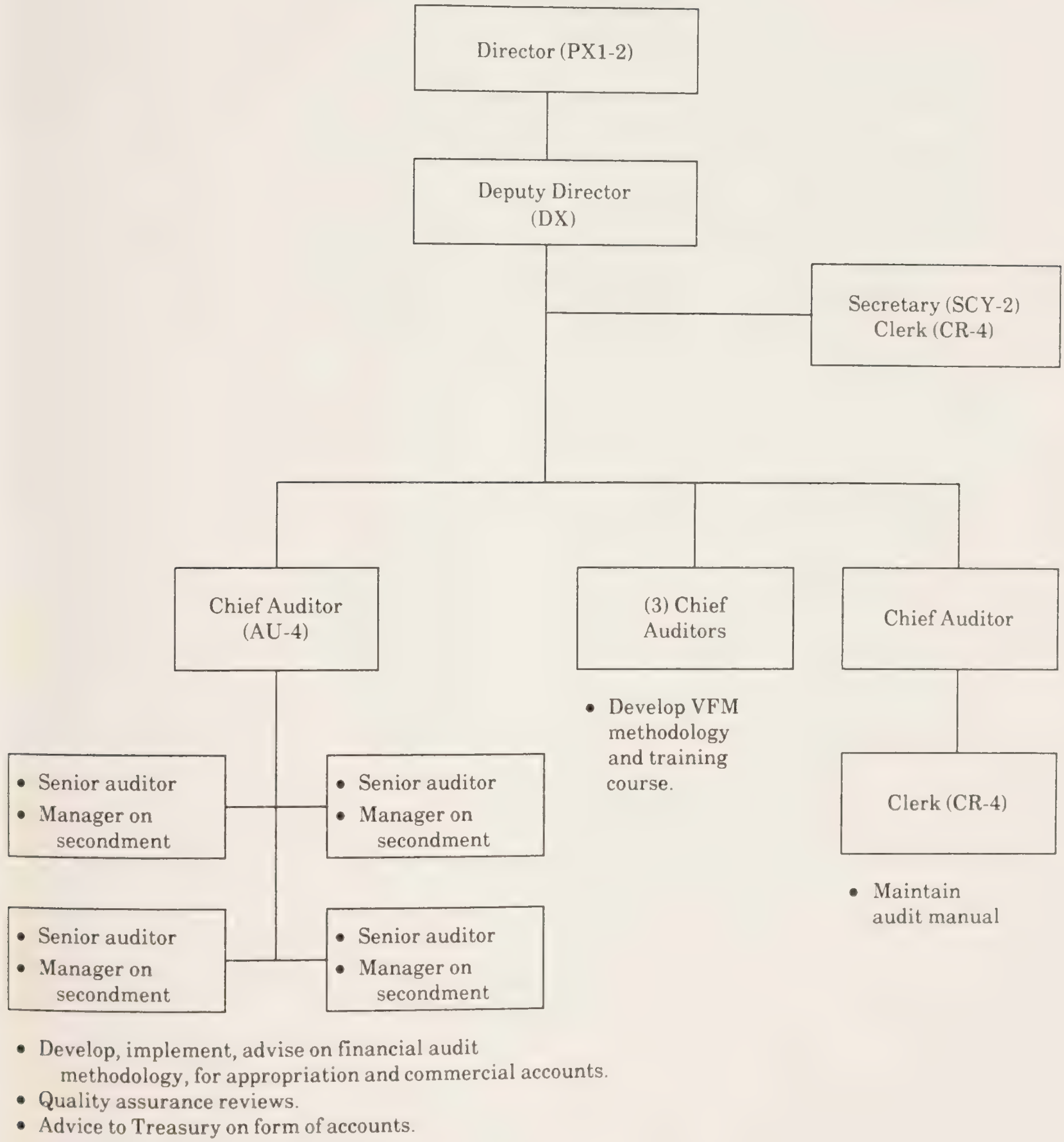

Figure II: Audit Guidance Division Costs 1983-84 (approximate)

-	Methodology development and advice to teams (Financial - $265,000; VFM - $45,000)	$ 310,000
-	Quality Assurance (Financial audit only)	114,000
-	Development of VFM Training Course	46,000
	Approximate Total Cost of Audit Guidance Division	$ 470,000

*Costs have been approximated by using known NAO salary rates for each grade of personnel in the Audit Guidance Division, apportioning cost between activities based on discussions with the Director of the Division, and converting sterling to Canadian dollars at an approximate rate of exchange.